

Kazakhstan's membership of the Eurasian Customs Union: Implications for trade and WTO accession

ADAM HEAL* AND TEODORA MLADENOVIC**

Summary

- Kazakhstan joined the Eurasian Customs Union (ECU) with Russia and Belarus in 2010 leading to changes in Kazakhstan's tariff schedule and non-tariff measures (NTMs).
- By 2015, tariffs will nearly have doubled on a trade-weighted basis from 2009. NTMs have also become more trade restrictive. This has led to some trade diversion towards ECU partners and away from other trading partners, in particular the European Union and China.
- Kazakhstan has been negotiating World Trade Organization (WTO) membership since 1996. Eurasian Customs Union membership has further complicated negotiations over WTO accession.
- Maintaining openness to trade and investment, not least the efficient sourcing of imports, will be important for Kazakhstan's international competitiveness as it seeks to diversify the economy away from dependence on natural resources.

* Adam Heal is an Associate Economic Affairs Officer, Trade and Investment Division, United Nations Economic and Social Commission for Asia and the Pacific, Bangkok.

**Teodora Mladenovic was an intern in ESCAP Trade and Investment Division during the preparation of this brief.

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1. Introduction

Economic diversification is a priority for Kazakhstan as it seeks to move away from a high level of dependence on extractive industries, including fossil fuels, minerals, and metals. Today, petroleum accounts for more than 60% of exports, and the top 20 export products alone account for almost 90% of exports. Greater efforts will be needed to diversify Kazakhstan's economy in order to support broad-based economic development and to reduce some of the macroeconomic volatility that can arise from shifts in global commodity prices.

Market access to key export destinations and inward foreign investment will be important contributors to successful diversification. In particular, the competitiveness of Kazakhstan's businesses, especially in sectors outside the extractive industries, will depend on the ability to efficiently source and import inputs as well as export final or intermediate products. Trade policy, including Kazakhstan's tariff regime as well as non-tariff barriers, is thus an important component of its overall development strategy.

Kazakhstan is currently negotiating membership in the WTO. Membership will bring potential benefits including greater, and more secure, market access for Kazakh products to both new and established markets; a reformed regulatory and legal environment will also increase the appeal of Kazakhstan as a destination for foreign investors. However, despite progress made in improving the foreign trade regime by lowering various trade barriers and increasing transparency and predictability of trade policy measures, WTO membership negotiations have still not been concluded with not much progress reported during recent meetings.

What was revealed in the recent WTO discussions is that the main areas of contention over WTO membership are: tariff rates; sanitary and phyto-sanitary (SPS) measures; and measures not consistent with WTO disciplines on trade-related investment measures (TRIMS), including those related to state-owned enterprises. Additionally, further problems have arisen in connection with Kazakhstan's membership, since 2010, in the Eurasian Customs Union (ECU)¹ with the Russian Federation and Belarus. In particular, there is disagreement over reconciling tariff rates previously negotiated in bilateral market access arrangements with Kazakhstan's new ECU tariffs.

This policy brief reviews the consequences of Kazakhstan's membership in the ECU for its trade policy, including the impacts of the common external tariff on its trade

¹ The full name is the Customs Union of the Eurasian Economic Community but this paper will follow others in using the shortened name 'Eurasian Customs Union'. The ECU also follows other similarly-named post-Soviet integration initiatives. For instance, the current ECU grew out of the Eurasian Economic Community (EurAsEC) dating back to 2000 which also includes Kyrgyzstan and Tajikistan but fell short of delivering an effective customs union. See Box below and also Dragneva and Wolczuk (2012) for a fuller contextualization of the ECU in light of past integration initiatives.

partners. The note then considers Kazakhstan's prospects for accession to the WTO in light of ECU membership.

2. The Eurasian Customs Union: Overview and implications for Kazakhstan's tariff regime

As part of efforts to deepen regional integration, Kazakhstan joined a customs union agreement with Russia and Belarus that came into force in January 2010. Together the three members have a consumer market of around 170m people and an estimated GDP of \$2.3 trillion (World Bank, 2014). Going beyond previous efforts towards regional integration (see box), the ECU has adopted a common external tariff and in future plans to introduce the free flow of goods, services, capital and labour within the territory of the ECU. As a step towards this deeper integration, in February 2012 the Eurasian Economic Commission began operations. The Commission will serve as the regulatory authority for the Customs Union.

Box: The Eurasian Customs Unions: Origins and Key Milestones

- 1995 – Russia, Belarus and Kazakhstan sign a treaty on the formation of a customs union. (Kyrgyzstan later joined in 1996, followed by Tajikistan in 1997.)
- 1999 - Belarus, Kazakhstan, Russia, Kyrgyzstan and Tajikistan sign the Treaty on the Customs Union and the Single Economic Space.
- 2000 - Grouping transformed into the Eurasian Economic Community (EurAsEC). Some progress towards free trade but many exemptions, quotas and special measures remain.
- 2006 – At EurAsEC summit, divergences among EurAsEC members led to Russia, Kazakhstan and Belarus deciding to act as a vanguard and push ahead towards customs union.
- 2007 - Treaty setting up the Eurasian Customs Union between Russia, Belarus and Kazakhstan signed.
- 2010 (January) - Common customs tariff launched. ECU Commission starts work.
- 2010 (July) Common customs territory becomes effective. ECU Customs Code enters into force.
- 2011 - Internal physical border controls eliminated.
- 2012 (January) - Single Economic Space inaugurated. EEC Court is set up.
- 2012 (July) - Eurasian Economic Commission (replacing the ECU Commission) becomes effective.
- 2015 - Planned start of the Eurasian Economic Union.

Source: Dragneva and Wolczuk (2012); Eurasian Commission (2013)

By joining the ECU, Kazakhstan effectively adopted the tariff profile of the Russian Federation (with some exceptions which are intended for elimination by 2015). Indeed,

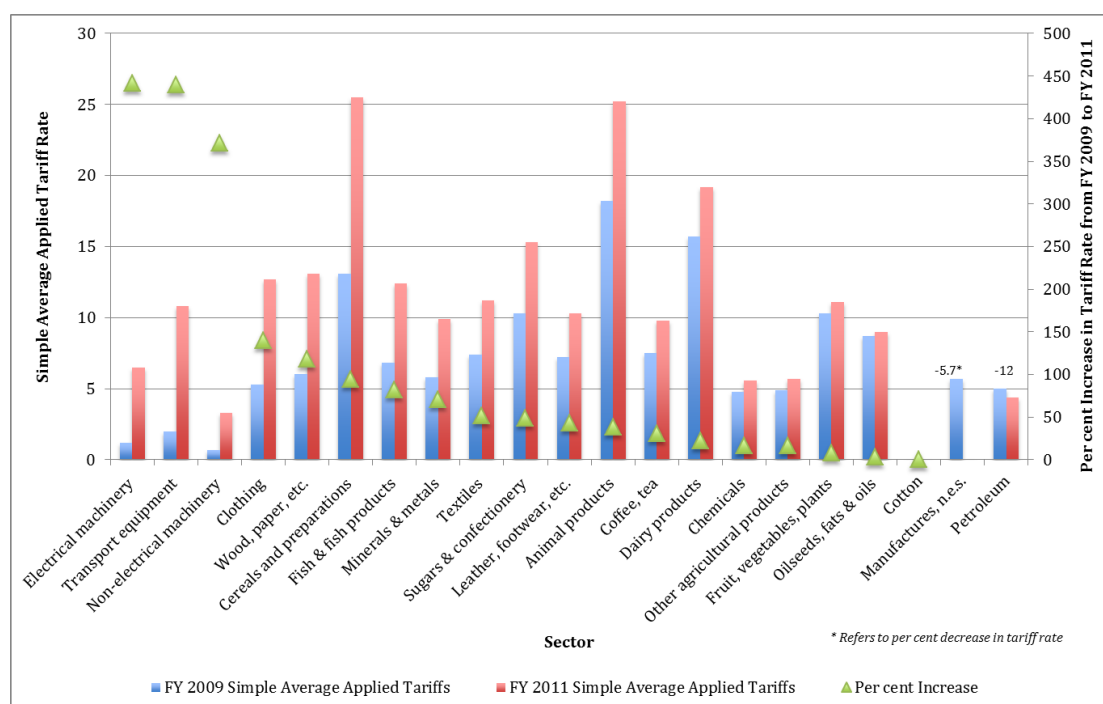
as a result of its membership in the ECU, Kazakhstan has increased the tariff rate on some 5,400 tariff lines. Likewise, the number of tariff lines with zero tariffs dropped from 1164 in 2009 to 641 in 2012 (Mkrtchyan, 2013). However, around 40% percent of tariff lines were already identical for all three members prior to the customs union. Kazakhstan also uses tariff-rate quotas (TRQs) for imports of beef, poultry, and pork, as is now required by the ECU.

While the impact of these changes was not uniform across sectors, overall there was a noticeable increase in the level of tariffs as reported by the WTO. Overall, non-agricultural tariffs increased more than agricultural tariffs between 2009 and 2011. Mkrtchyan (2013) found a rise in the mean MFN tariff from 6.49 in 2009 to 10.74 in 2012. Another study found that by early 2011 the average external tariff had increased by around 78 per cent on a trade weighted basis from the pre-customs union 2009 level (Shepotylo, 2011).

The dispersion of the tariff also increased suggesting potentially greater economic distortion (Jandosov and Sabyrova, 2011). By 2015 when the exceptions to the common external tariff are eliminated, tariffs will have almost doubled on a trade-weighted basis; among comparable middle-income countries Kazakhstan now has the highest level of tariff protection (Jandosov and Sabyrova, 2011).

Changes in tariff rates vary considerably by sector. The highest increases in percentage terms have been in: electrical machinery, transport equipment and non-electrical machinery (figure 1). The five specific sectors that saw the largest increases in absolute terms were: electrical machinery, transport equipment, non-electrical machinery, clothing, and wood, paper, etc. The highest absolute rates are now on 'cereals and preparations' and animal products. Only two sectors saw falls in simple average applied tariffs, namely manufactures which was lowered by 5.7% and petroleum which fell by 12%

Figure 1: Kazakhstan's average tariff rates by sector pre- and post-Customs Union



Source: ESCAP calculations based on WTO, World Tariff Profiles.

Russia's WTO accession will have an impact on the future direction of tariff rate changes for the ECU. It has apparently been agreed by ECU members that the common external tariff of the ECU will be altered to accommodate Russia's WTO commitments (Tarr, 2012). Tarr estimates that this will reduce the applied un-weighted average tariff, which will fall in stages from 10.9 percent in 2012 to 7.9 percent by the year 2020 (Shepotylo and Tarr, 2012).² Consequentially, the costs to Kazakhstan of trade diversion caused by the ECU will fall.

3. Non-tariff measures

Non-tariff measures (NTMs) – typically regulations affecting trade such as product standards or labeling requirements – can turn into major barriers to trade. While often serving legitimate purposes like protecting public health, NTMs can also be onerous and difficult for importers to comply with. NTMs can thereby pose both intentional and unintentional restrictions on trade. When NTMs restrict the sourcing of imported inputs this can have detrimental consequences for competitiveness. Where numerous

² Russia's "bound rate" is at 8.6 percent on an un-weighted average basis; but for 1,500 tariff lines the applied rate is below the bound rate. Tarr (2012) estimates that the applied weighted-average tariff will fall between 2012 and 2020 from 9.3 per cent to 5.8 per cent.

government departments or agencies have some authority over NTMs their overall implementation can be fragmented, poorly coordinated and lacking in oversight.

Prior to joining the ECU, licensing requirements and quotas were identified as the most significant barriers for exporters seeking access to Kazakhstan's market (Tarr, 2012). Kazakhstan had, however, made steps to harmonize NTMs with those of the European Union, thus enhancing transparency and predictability for traders. After joining the ECU, Kazakhstan's standards and regulations are being aligned with those of the Russian Federation leading to more stringent standards and technical regulations with the overall impact being increased protectionism.

In particular, SPS and TBT standards have become more onerous as Kazakhstan has adopted Russia's policy approach which is still informed by the Soviet-era style GOST³ standards. These standards are used to control the quality of a product, and are often more stringent than those used in other major markets. As such they are deemed to hinder innovation and make adoption of new products or processes expensive, since the producers must negotiate with regulators about how to change the product (Tarr, 2012). For instance, in 2012 Russia's Ministry of Health prepared a regulation on emissions from volatile organic compounds used as solvents in glues in many furniture items. This was to be applied across the ECU and would impose standards twice as strict as those required by the EU.

Import licensing is also widely used within the ECU on goods such as: precious metals and stones, encrypted technologies, documents from national archives, and items of cultural value. However, as the ECU has now broadly implemented Russia's WTO commitments, import licensing for pharmaceuticals and alcoholic beverages has been eliminated (USTR, 2012).

Other NTMs still hinder intra-ECU trade. For instance, Kazakhstan has raised complaints against Russia on SPS and TBT measures. Anecdotal reports suggest the SPS and TBT measures are still being used by Russian authorities to protect markets, or are sometimes non-transparently administered leading to costs for Kazakhstani exporters (Tarr, 2012).

For Kazakhstan, it will be important to streamline NTMs in order to improve business competitiveness. The government is currently planning to move from mandatory to voluntary certification on technical regulations. Additionally, further work will be needed to improve the import related infrastructure (i.e. factories, testing facilities, etc.) within the ECU countries in order to fully implement MRAs. A critical question is whether accession to the WTO will reduce the trade-restrictive NTMs that have been introduced through the ECU.

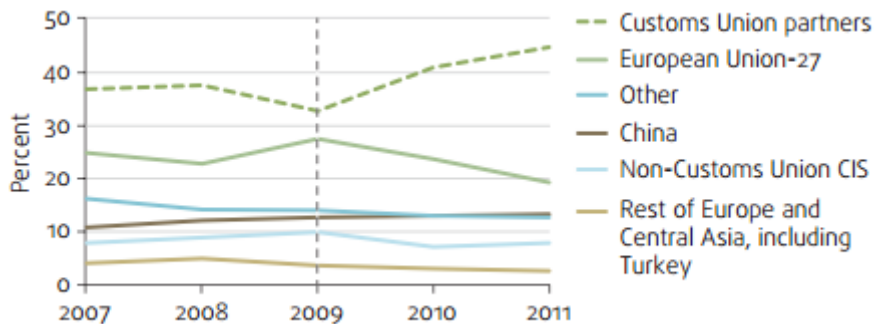
³ From the Russian: gosudarstvennyy standart (государственный стандарт), which means state standard.

4. Consequences for Trade

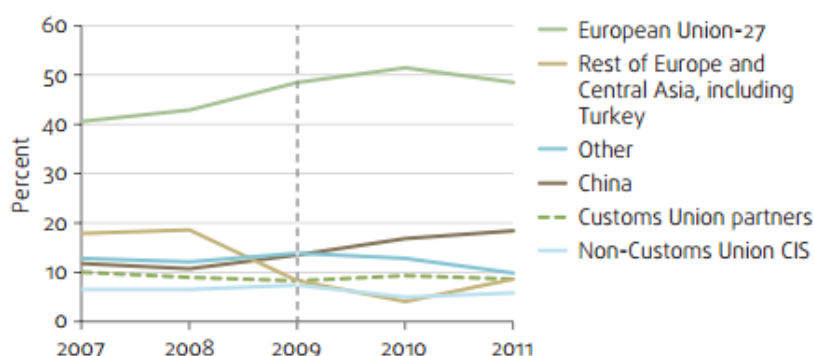
Regional integration and trade with ECU partners will remain important for Kazakhstan but it is vital that the ECU does not restrict broader integration into global and Asian markets. As noted, the adoption of a common external tariff by the ECU saw Kazakhstan align its tariffs with those of the Russian Federation. NTMs have also been aligned, leading to more protectionist regulations in some sectors. Together, the increased restrictiveness of Kazakhstan's trade regime has led to some diversion of trade away from optimal suppliers of inputs and towards those from ECU partners, as explained below.

Isakova and Plekhanov (2012) investigate the impact of the customs union on the structure of imports in Kazakhstan. They found some increase in imports from Russia at the expense of other trade partners (so-called, trade diversion). However, they note that Kazakh-Russian trade had fallen before the ECU became effective, creating the possible problem that increases in bilateral trade could be due to a natural recovery. China and the EU are the two trading partners most affected by Kazakhstan's ECU membership. Imports from the EU have fallen as a share of total imports since the introduction of the common tariff while imports from ECU partners (essentially Russia) have grown (figures 2 and 3).

Figure 2: Kazakhstan's imports by source



Source: World Bank (2014), p121

Figure 3: Kazakhstan's exports by destination

Source: World Bank (2014), p121

Attempts to model the wider economic impact of ECU membership have estimated that (as of 2011) Kazakhstan is losing about 0.2 per cent in real income per year as a result of participation in the ECU – mainly as a consequence of the higher external tariffs (World Bank, 2012). Similarly, the study estimates that the ECU has depressed real wages by 0.5 per cent. As Kazakhstan trades less with the rest of the world and more with Russia, this is likely to have longer-term economic consequences. A reduction in trade with the more technologically advanced countries of the EU will lower rates of imported technology and reduce productivity gains in the long run.

Other studies have estimated that progress within the ECU on non-tariff barriers and trade facilitation could outweigh the negative impact of the tariff changes for Kazakhstan (see World Bank, 2012; Tarr, 2012). Unfortunately, so far the Customs Union has not made adequate progress on either non-tariff barriers or trade facilitation to realize these potential gains.

5. Accession to the WTO: Problems and prospects

WTO accession would bring long-term benefits to the economy and be a strong signal of commitment to economic reform and opening. As Kazakhstan has already negotiated MFN treatment with most of its major trading partners, WTO accession will not immediately lead to major market access improvements in principle export markets. Accession would, however, bring additional rights in relation to trade safeguards such as antidumping and countervailing duty investigations (Jensen and Tarr, 2007). Greater openness to imports of goods, and crucially services, will also bolster economic competitiveness improving the variety of imports available and lifting productivity. Other substantial gains will be more long-term in nature and will derive from the reduction in corruption and the liberalization of foreign investments. This though suggests that membership of the WTO without accompanying institutional reforms will be insufficient.

Kazakhstan's accession to the WTO has been a drawn-out process. The Working Party of Kazakhstan's accession to the WTO was established on 6 February 1996 and Kazakhstan applied for WTO membership in April of that year. Bilateral Market Access negotiations began in October 1997. The most recent WTO meeting on the topic of Kazakhstan membership took place on 23rd July 2013. While such lengthy negotiations have not been uncommon, particularly for economies in transition where many issues regarding ownership, regulation and competition in the state-owned sector can cause complications, it will be important for Kazakhstan to finalize accession in a timely manner.

Throughout 2012, Kazakhstan made substantial progress towards completing the requirements for WTO membership. Areas of further improvement were identified and its Legislative Action Plan was revised (WTO, 2013). At the last Working Party meeting in December 2012, the members identified the remaining issues that Kazakhstan needed to tackle in order to become a WTO member. Major unresolved issues include:

- **Market Access** – Before Kazakhstan joined the ECU it signed bilateral market access agreements with many WTO members, as well as committing to lower tariffs than those currently in the ECU. Many WTO member-states have reacted negatively against the methodology proposed for adjustment of this discrepancy. One solution would be for Russia (and the ECU) to lower its bound rates on the 1,500 tariff lines where the bound rates are presently above the applied rates. In March 2013, the Russian Federation suggested a formula that would allow the adjustment of the common tariff on the goods in accordance the share of markets of these goods.
- **Local Content Requirements**– Kazakhstan maintains strong support for local content requirements in government procurement and purchases, including those made by state owned enterprises. A supplier must receive a certificate from the Ministry of Industry and New Technologies that confirms the extent of the goods or service's local content. Starting January 1, 2014, companies from EEC countries will enjoy local content treatment for the goods and services that they supply. Kazakhstan is not a member of the WTO Government Procurement Code.
- **Intellectual Property Rights protection** – To facilitate its WTO accession and attract foreign investment, Kazakhstan is modernizing its legal regime for protecting intellectual property rights (IPR). In the period 2009-2011, Kazakhstan adopted several amendments to its IPR law, including the recognition of vendors that have the legal right to sell certain print and digital media. Kazakhstan has taken steps towards implementing international IPR standards. For example, the government introduced amendments to its trademark legislation with a view to

complying with the WTO TRIPS Agreement. Kazakhstan has also ratified 16 of the 24 treaties endorsed by the World Intellectual Property Organization (WIPO).

Other problems include: issues associated with state-owned enterprises; tariff rate quota volumes and administration; export duties; discriminatory VAT practices; technical regulations; and trade-related measures. A positive outcome from the last meeting was that Kazakhstan agreed to bind export subsidies at zero upon accession, among other things. Tariff quotas that Kazakhstan has with the US will also need to be addressed in order to become a member of the WTO.

Finally, despite progress made so far, there is further to go on the road to a fully diversified economy. To drive diversification and increase growth in sectors with greater value added, greater attention will be needed to: improving the transparency of the investment regime and facilitating SME access to finance. Notably, investment will be needed into light manufacturing and processing. Integration in regional production networks can be part of this approach and will require a strengthening of logistical and transport links with other markets. More development of the services sector - increasingly known to be essential to supporting manufacturing and other activities - is also vital. Improved trade and investment policies in this area, including through WTO membership, can help in this regard.

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ARTNeT Secretariat, United Nations ESCAP

Rajadamnern Nok Avenue

Bangkok 10200, Thailand

Tel: +66(0) 22881410

Fax: +66(0) 22881027